

**Page Denied**

FOLLOW-UP

# Can OPEC Survive the Glut?

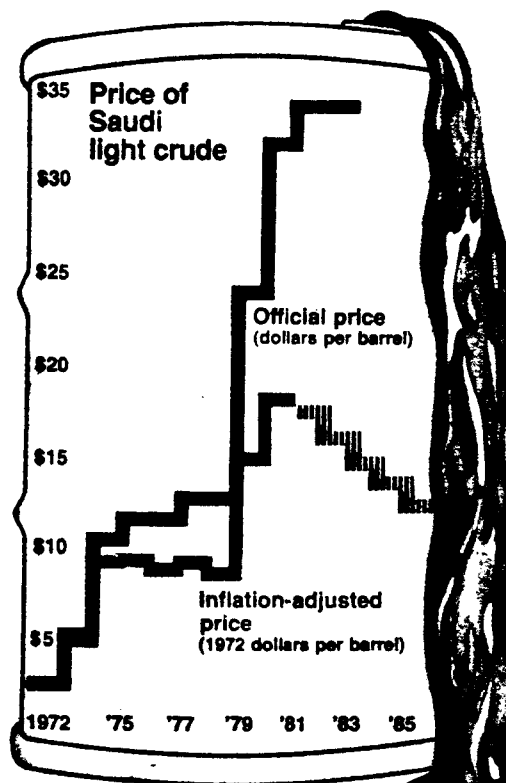
by WILLIAM M. BROWN

In FORTUNE last year, William M. Brown and Herman Kahn of the Hudson Institute presented a seemingly far-out analysis of the future of OPEC and oil prices ("Why OPEC Is Vulnerable," July 14, 1980). OPEC's oil exports, they argued, would shrink during the 1980s and oil prices would decline, not keep rising as almost everybody then believed. Rosy though they seemed, the Brown-Kahn predictions derived from careful analysis, and they soon began coming true. In the following article, Brown, a physicist and director of energy studies at Hudson, takes an updated look at OPEC's prospects. His analysis suggests that they've grown even bleaker.

Despite the much-noted oil glut, Americans generally still appear to believe that oil prices will continue moving up in the years just ahead—that, after all, is what experts have been telling them. According to my analysis of the oil outlook, this picture of the future is quite mistaken. We are in for lower, not higher, oil prices. It is pretty safe to predict that world oil prices in 1985 will be lower in real terms than the unified official price of \$34 a barrel agreed upon at the OPEC meeting in Geneva in late October. The official price in 1985 may be higher than \$34, but inflation and discounts will probably bring real selling prices considerably below \$34 in 1981 dollars.

The glut has already reduced OPEC's oil exports from a 1979 rate of over 28 million barrels per day (mbpd) to less than 21 mbpd currently, and there is no reason to expect exports to get much higher than

that for at least a few years. Consequently, competition for market shares within OPEC is likely to increase and to result in further price declines in real terms. After two or three years, a downward price spiral resulting from these economic pressures could even bring an end to a pervasive illusion of the 1970s—that OPEC is a powerful cartel that can impose its will on the marketplace.



Some observers describe the current glut as a short breathing space that will end soon when OPEC gets its act together. OPEC did get its act together to some extent at Geneva, and afterward Sheikh Ahmed Zaki Yamani, the Saudi oil minister, announced that Saudi Arabia would cut its output to 8.5 mbpd to support the new \$34 price—a cut of about a million barrels a day. That, he predicted, will bring the glut to an end. Nonetheless, I expect that the glut will grow larger. There are at least seven reasons to think so:

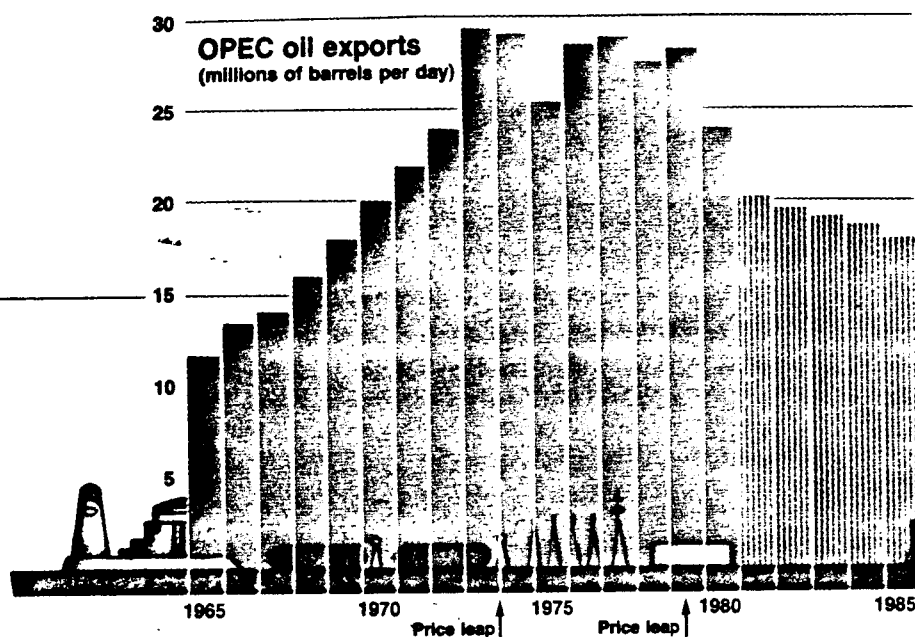
■ **Energy conservation.** Since the Arab oil embargo, the impact of energy conservation in the major industrialized countries has been impressive. Energy efficiency should continue to improve at least through the remainder of this century. Technological improvements already scheduled point to efficiency gains of 30% to 50% in motor vehicles and in energy-intensive industrial processes.

■ **Switching to alternative fuels.** For the next 20 years, significant growth is likely in the worldwide consumption of energy from sources other than oil—coal, natural gas, nuclear power, hydroelectric power. As a rough estimate, over the next two decades switching to alternative fuels may be equivalent to discovering each year a new giant oil field that would produce between 0.5 and 1.0 mbpd.

continued

## Downhill from Here

Between the surges of 1973-74 and 1979-80, oil prices declined somewhat in real, inflation-adjusted terms. Now they're headed downward again. The chart shows year-end prices, so the official price for 1981 is \$34, the figure OPEC announced in October, adding that it would hold through 1982. Continuation of this price past 1982 is assumed in the projections of the inflation-adjusted price. These projections by author William Brown are based upon an average inflation rate of about 9%.



## OPEC Pays a Price

During the Sixties, OPEC's export volume grew 10% a year, but growth stopped after the price leap of 1973-74. Exports never regained the 1973 high. After oil prices more than doubled in 1979-80, export volume went into what threatens to be an extended decline. In short, demand has responded to prices—just as basic economics says it should.

■ **Slowed economic growth.** For the industrialized countries as a whole, the OECD expects economic growth in 1981 to be a little more than 1%, about one-third of "normal." A return to the vigorous growth rates of the Sixties and early Seventies appears at least a few years off.

■ **Inventory reduction.** Early this year, stocks of petroleum in importing countries were close to their all-time peaks. The above-normal amounts held by governments, oil companies, and consumers might add up to as much as 1.2 billion barrels. Both oil companies and consumers can be expected to reduce inventories toward normal during a prolonged glut.

■ **Non-OPEC production.** Since soon after the Arab oil embargo of 1973-74, non-OPEC oil production has been climbing fairly steadily by 5% to 6% a year. Based on existing oil discoveries and investments in oil-field development, this growth appears sustainable over at least the next few years. Even beyond the next four or five years, there appears to be a reasonable chance of maintaining a 5% growth rate for a while, because of the current unprecedented level of effort in the worldwide search for new oil and gas fields.

■ **Production from Iraq and Iran.** As a result of the stalemated war between Iraq and Iran, oil production in those countries together is running about 4 mbpd below their 1979 output. In two or three years, if not earlier, it is quite possible that Iraq and Iran will find some face-saving exit from their conflict and that most of the war damage will be repaired. Any rise in their production would, of course, put addition-

al pressure on the other members of OPEC.

■ **Falling oil prices.** If oil prices are flat or declining in real terms over the next few years, as I expect, some OPEC countries will probably attempt to increase their export volumes as a way of keeping their income up. The dilemma facing each member is that the only effective way of accomplishing this is likely to be through price reductions. Each such action, however disguised, could then spur other OPEC countries to cut their prices (or increase discounts). A downward price spiral could follow, the bottom of which can only be conjectured.

One way for OPEC to counteract the impact of these seven factors would be to establish a system of production quotas. However, the outlook for effective agreements of this type in OPEC is dim.

### A double burning

Without either quotas to hold down supply or a sharp drop in prices to lift demand, the only factor that could significantly ease the current oil glut would be an outbreak of serious disturbances involving oil-exporting countries. Thus, one can easily imagine a renewed escalation of fighting between Iraq and Iran or the eruption of mass riots, revolutions, or wars in other OPEC countries, or even a new war between Israel and some Arab country. But such events are not likely to alleviate the current glut enough to stabilize or increase prices for any extended period, as long as nothing comes along to close down Saudi production.

Declining prices in the early 1980s

would increase demand for oil, but by how much? I expect oil demand to be less responsive to declining prices than other commodities would be. After all, consumers and businesses in oil-importing countries were burned twice, by price surges in 1973-74 and 1979-80. Those experiences will linger in our minds for decades.

Lower oil prices over a few years are likely to be interpreted as a trap into which no alert nation, or business, should fall. Declining oil prices might induce government intervention—for instance, tariffs—to keep the domestic price of oil artificially high and ensure that dependence upon oil imports will not increase. Governments would be glad to get the additional revenue too, of course.

Gradual price erosion, then, is unlikely to reverse the declining trend in demand for OPEC oil anytime soon. With the already wide gap between OPEC production capacity and OPEC exports growing wider still, a Saudi production cut to about 5 mbpd might be required, even before the end of 1982, to maintain the \$34 price. Moreover, an additional cut of perhaps 2 mbpd might be needed by the end of 1983. Economic analysts believe that if Saudi exports should fall below about 6 mbpd, the government would probably have to cut back the country's economic-development budget—unless the Saudis are confident enough about the future to draw down their cash reserves.

If the Saudis choose to reduce their output to 5 mbpd during 1982 to defend the \$34 price, they could find themselves looking at 1983 and beyond with trepidation.

*continued*

# **FOLLOW-UP**

tion. My estimate for total OPEC exports for 1985 is 18 mbpd (see chart page 90). That level could be perhaps 12 or 13 mbpd below OPEC's maximum sustainable export capacity. Also, a constant \$34 price in nominal dollars for another four years implies roughly a 30% decline in real income even for OPEC members that maintain their export volumes. Unfortunately for OPEC, attempts to gain greater market shares for individual members would also tend to make oil prices fall more rapidly for them all. The situation suggests that oil prices have already reached their peak for the early 1980s, if not for much longer.

## **Trial by glut**

Although OPEC is generally referred to as a cartel, it has never behaved like one. Any producers' association may appear to be in relatively strong control of pricing and production arrangements during a rising market. The crucial test of effectiveness, however, occurs when the organization is faced with a declining market—a glut, not a shortage.

On the record, OPEC was not successful from 1974 through 1978. During that span the inflation-adjusted price of petroleum actually declined, as the chart on page 89 indicates. OPEC was temporarily "saved" in 1979, not by its wisdom, but by the prolonged oil-buying panic that followed the revolution in Iran. After the market began to soften again in mid-1980, a new rescuer appeared in the form of the Iraq-Iran war. Now OPEC is facing the beginning of another major test—one that could threaten not only its income, but its existence.

A strategy of deliberately moving oil prices lower might help to save OPEC, if anything can. In the absence of an OPEC agreement on production quotas, the Saudis alone cannot be expected to cut their output enough to keep real oil prices from falling. To support the official price might require the Saudis to surrender their entire export market by 1985, an obviously unacceptable outcome.

What we can expect over the next few years, then, is gradual erosion in real oil prices, probably with official OPEC prices

remaining stable or going up very little. A faster price retreat, with actual cuts in official prices, would make sense on economic grounds, but that would stir up internal political troubles. Arabs tend to look upon their oil reserves as a precious national heritage; price-cutting can easily be interpreted as an outrageous act—like selling the family jewels to a pawnbroker.

In view of all this, the Saudis—indeed all OPEC members—may soon become enmeshed in a Catch-22 situation. To follow an intelligent long-range plan, deliberately lowering prices, may invite political ruin. But if the Saudis don't take that course, economic forces may make a shambles of the international oil market within a few years. After that, no one could confidently foresee how low prices might fall or what the political consequences would be.

The spot market is likely to remain soft for a long time. Within the next few months, some member countries will probably be offering oil at discounts from the \$34 "official" price, perhaps \$1 to \$3 per barrel. By 1985, and possibly much sooner, the official OPEC prices could completely unravel. The struggle for market shares may by then have caused prices to decline substantially—perhaps to less than \$20 per barrel in 1981 dollars. Indeed, they might even sink below \$15.

## **A road to de-escalation**

Economists and businessmen generally agree that the prospects for long-term economic stability and prosperity worldwide become better if prices of important commodities vary gradually—in "small doses," as Sheikh Yamani put it—within a reasonable and predictable range. Saudi Arabia appears to be the only OPEC country that both understands this point and, for its own reasons, *cares* about it. The ideal Saudi strategy would help bring oil prices into such a range and keep them there over the long term—not out of altruism, but because the Saudis are convinced that it would be best for them.

Let us assume the Saudis conclude that their long-term economic and political in-

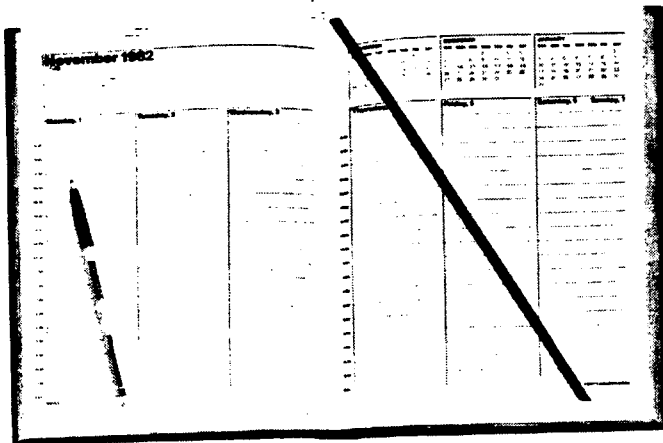
terests would be much better served by oil prices somewhat lower than \$34 per barrel (in 1981 dollars), perhaps \$25 per barrel. In the oil-importing countries, expectations of a stable real price equivalent to \$25 in 1981 dollars would probably cause the delay or cancellation of many of the high-cost energy projects now contemplated. For example, synthetic fuels from coal or oil shale are usually justifiable only at prices between \$30 and \$60 per barrel. And exploration for conventional oil and gas in many frontier regions could become only marginally interesting at the \$25 price. Lower oil prices would probably discourage the Alaskan natural-gas pipeline, postpone development of tar-sands projects, reduce the desirability of switching to coal, postpone some investments in conservation, and increase current appetites for petroleum fuels. Lower oil prices also would mean stronger economic growth in oil-importing countries, and that would help buoy demand for OPEC oil.

## **Preparing for the shock**

If the Saudis undertake to bring oil prices down, how might they proceed? In early 1982, discounts and sinking spot-market prices may well push the effective price two dollars or more below the \$34 official price. The Saudis will then find that some of their market is about to slip away to OPEC competitors. A plausible scenario of what comes next might run as follows: In the spring of 1982 the Saudis—for political reasons—announce a small cut in output, 0.5 mbpd, and play it up as a move to support prices, even though they want the decline to continue. An OPEC meeting in May, let's say, fails to change the official price or to reach a production agreement. By August the Saudis have prepared their populace for the shock: they announce that widespread discounting and predatory practices of some exporting countries have forced the government to reduce the official price of Saudi light crude back to \$32. Again for political reasons, they also promise another 0.5-mbpd production cut late in the year. The Saudi cutbacks, however, barely match the decline in total

*continued*

# Let FORTUNE organize your life next year.



## Order your copy of the 1982 FORTUNE Desk Diary today.

The FORTUNE Diary ranks among the world's most distinctive desk diaries. It's printed on the finest quality gift-edged paper and is bound in elegant dark grey. The Diary measures 8¾" x 11¼" and is available only through FORTUNE.

The Diary covers 14 months, from December 1981 through January 1983. The pages lie flat for easy use. Each two-page spread shows the current week at a glance with space for noting appointments at half-hour intervals. Calendars at the top of each right-hand page show the previous, current, and upcoming months.

**Plus three famous FORTUNE directories.** Bound into the Diary are the FORTUNE 500 Directory, the Second 500, and the Top 50 companies in each of six non-industrial groups. You'll have the performance record of 1,300 companies at your fingertips.

**An appropriate gift.** The FORTUNE Diary makes an excellent gift for friends, business associates, and clients. It's useful, good looking, and reasonably priced. One to four copies cost \$19.50 each, plus \$1.60 each for handling and shipping. Five to nine copies cost \$15.50 each; ten or more \$13.50 each. In all cases, please add \$1.60 each for handling and shipping.

(Residents of Canada: Amount levied by Canadian Customs will be added.)

**Reserve today.** A limited number of Diaries is being printed so send your order today. Mail with your check to The FORTUNE Diary, 541 North Fairbanks Court, Chicago, Illinois 60611. Or call toll-free (800) 621-7309; in Illinois, (800) 572-9483. Your order will be filled in time for holiday gift giving.

**FORTUNE** THE FORTUNE DIARY  
541 NORTH FAIRBANKS COURT, CHICAGO, ILLINOIS 60611

Please send me \_\_\_\_\_ copies of the 1982 FORTUNE Diary:

- 1-4 copies \$19.50 each plus \$1.60 each for handling and shipping
- 5-9 copies \$15.50 each plus \$1.60 each for handling and shipping
- 10 or more copies \$13.50 each plus \$1.60 each for handling and shipping

Local taxes additional where applicable. Allow six weeks for delivery

☐ My check for \$ \_\_\_\_\_ is enclosed ☐ Bill me later

NAME \_\_\_\_\_

ADDRESS \_\_\_\_\_

CITY \_\_\_\_\_

STATE \_\_\_\_\_

ZIP \_\_\_\_\_

(Residents of Canada: Amount levied by Canadian Customs will be added.)

3AA JG5

**FOLLOW-UP**

OPEC exports. The formal Saudi price reduction dismays some members of OPEC, but those unwilling to face further shrinkage of their export volume have to match the new \$32 price, either openly or through discounts.

The Saudis repeat this process, letting market forces erode official prices through inflation and discounts, then lowering their official price to meet the competition and at the same time announcing a small production cut. Their goal is to establish by mid-1983 if not sooner a stable market for OPEC exports at stable real prices. This market, at, say, \$30 a barrel in 1983 dollars (about \$25 in 1981 dollars), should absorb about 21 mbpd of OPEC supplies, with the Saudis furnishing about 7 mbpd. At that point, OPEC, now clearly under Saudi leadership, meets and announces that future prices will be increased regularly to keep up with inflation—perhaps a little bit more. Presumably OPEC has learned the lessons necessary to maintain a reasonably stable long-term market.

### The no-win prospect

While the numbers in this scenario are unavoidably somewhat arbitrary, they indicate how this phase of the Saudi strategy might be brought to a successful conclusion with minimum trauma to themselves and other OPEC members. If everything works out well for Saudi Arabia, OPEC's 21-mbpd export level would not decline any further during the 1980s, and should rise slowly during the following decade.

This ideal Saudi strategy, even if attempted, would not necessarily lead to a stable market. The Saudis would need luck as well as skill. A collapse of prices, and possibly of OPEC, seems a more likely outcome. However, it is just that kind of outcome the Saudis—and the oil-importing countries too—should want to prevent. The political turbulence following a price collapse might turn into chaos. And neither the OPEC countries nor the oil-importing countries are likely to profit from the unpredictable large swings in oil prices that could well follow. Over time we might all be losers. [F]